BEFORE THE PUBLIC UTILITIES COMMISSION

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COMMENTS OF VERIZON REGARDING THE OCTOBER 5, 2007 ASSIGNED COMMISSIONER'S RULING ON ISSUES RELATING TO THE SCOPING AND SCHEDULING OF PHASE II ISSUES

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Verizon California Inc. (Verizon) respectfully submits these comments regarding responses to the Assigned Commissioner's Ruling on Issues Relating to the Scoping and Scheduling of Phase II Issues (Ruling) dated October 5, 2007. The Ruling solicits comments concerning the implementation of a reverse auction, updating of high-cost proxies, and other phase II issues. These comments are grouped according to the questions in the Ruling, and the questions are repeated for convenience.

INTRODUCTION

The comprehensive record of intermodal competition developed in the Uniform Regulatory Framework (URF) proceeding must continue to inform the Commission's policies as it enters Phase II of this proceeding. That record demonstrated that intermodal competitors such as wireless and VoIP have developed throughout the state without the benefit of CHCF-B support, and will continue to do so. As the Commission found there, competition is the best means of ensuring reasonable prices, the level of subsidies in the system should decline as competition increases, and market forces in high cost areas must be taken into account in addressing universal service.

The Commission has already taken significant steps in Phase I to narrowly target high cost support and substantially reduce the size of the B-fund as competition further intensifies. The B-fund should be competitively neutral, but broadening eligible participants should not increase the fund size. Likewise, any auction mechanism must implemented so as to continue to promote this targeted policy focus. For example, subsidies must be limited to truly high cost areas where no provider otherwise would economically provide quality services at just, reasonable and affordable rates. To avoid unnecessarily expanding the B-fund, subsidies in any given area must be limited to a single provider and a single connection per household, with the total amount of support available capped at pre-existing levels. Intermodal carrier participation in the B-Fund should be encouraged, but it should be strictly voluntary. Finally, conditions for participating

in an auction or satisfying a bid must not be so administratively onerous as to discourage willing intermodal providers form participating in the auction.

In determining relative cost levels between various geographic areas in order to identify truly high cost areas, the Commission should strive for a simple, efficient process that satisfies the objective of identifying high cost areas with sufficient detail to administer the CHCF-B program so as to meet the statutory goals. The Commission should strive for reasonable accuracy consistent with a recognition that these costs may be used in an intermodal context involving carriers whose costs differ from, and are not subject to the same level of scrutiny as, those of ILECs.

With regard to a transition to full pricing flexibility for basic rates, the Commission must recognize that continued rate caps following after January 2009 are fundamentally at odds with the pro-competitive policies and findings adopted in the URF decision. Any transition should be as limited as possible, balancing gradually increasing caps over a period long enough to provide a transition but short enough to keep regulatory influence over market mechanisms at a minimum.

RESPONSES TO QUESTIONS

A. REVERSE AUCTION DESIGN AND IMPLEMENTATION

We also solicit comments on the specific design and implementation of a reverse auction mechanism to determine B-Fund subsidy support levels and COLR status as a means of funding high cost support. Following review of comments on questions below, we intend to schedule a technical workshop as a forum to build consensus on the design and implementation of a reverse auction. Parties' comments will identify areas of agreement and also highlight issues requiring further analysis.

In designing a reverse auction mechanism for use at the state level, any such program must be crafted in a manner that will advance the overriding policy objectives discussed above as well as take into account state specific circumstances such as the current and future market conditions and legal framework. Earlier this year, Verizon developed a detailed proposal relying on

competitive bidding to distribute federal high cost support. Verizon's FCC proposal was designed to take into account the specific circumstances of the federal fund and to perform well in the setting of a nationwide, federal mechanism that must operate across many different markets.

In developing a reverse auction mechanism at the state level, the Commission faces some similar but also some different challenges, as well as market conditions that are specific to California. In many other parts of the country, the availability of high levels of federal support has attracted multiple competitive carriers to be certified as CETCs. Verizon was therefore able to propose to the FCC that auctions be implemented in a series of steps, with the first rounds of auctions held for wireless CETCs in places where potential bidders – more than one wireless CETC – already exist. In California, in contrast, there is only one CETC eligible for federal support, and only one competitive carrier has become a COLR under the Commission's existing rules. Thus, in designing an auction mechanism for California, the Commission must consider who the potential bidders might be, and how such parties would be qualified to bid. This in turn will affect the timing and design of the auction itself.

For these reasons, the challenge of designing an auction mechanism for the B-Fund must be approached with care. While Verizon's federal proposal provides a useful point of reference, it cannot simply be transferred to California without consideration of the circumstances of the California market. Indeed, there are several practical considerations that should be taken into account in the design of any California mechanism.

First, a universal service auction should be designed to ensure that any winning bidders will be capable of fulfilling universal service obligations in any areas where they receive state support. Competitive carriers do not generally serve as COLRs today in California,[1] and so the Commission must establish some process for certifying entities as qualified bidders. Verizon's proposal to the FCC largely relied upon the existing ETC certification process to perform that function. This was appropriate, since the Communications Act requires an entity

[1] Currently, Cox is the only non-incumbent carrier with COLR status drawing from the B-Fund,

to be an ETC in order to be eligible to receive federal high cost fund support, and in many parts of the country multiple CETCs have already been designated.

The same approach will not work in California, however, where only one CETC has been designated.[2] Thus, the Commission should adopt a process for certifying entities as qualified bidders in the B-fund auctions, focusing on whether the entity has the financial and technical capability to carry out the COLR obligation in any areas where they were to receive support. The certification process should be implemented, and qualified bidders designated, before any areas are put up for auction. The process of nominating areas for auction should then be informed by the availability of qualified bidders in each area.

Second, the Commission should consider how auctions should be structured and who should participate. Once again, the Commission faces circumstances different from those faced by the FCC. Under Verizon's proposal to the FCC, a series of wireless-only auctions would be held in study areas where more than one wireless CETC exists. These would then be followed by wireline auctions in those areas with a wireline CETC. The FCC would then consider its experience with auctions and evaluate a range of options including the possibility of more general auctions to select a single provider of universal service in high cost areas.

In contrast, there are no areas in California where multiple wireless CETCs have already been designated, so there is no need for an initial wireless only auction. At the state level, the qualified bidders could include the ILEC and one or more wireless or other wireline providers. Therefore, the Commission should consider the possible outcomes of such a general auction before it proceeds with auctions for the B-fund. For example, if a wireless carrier or another wireline provider won a general auction, what would the process be for transferring the COLR obligation from the ILEC to the winner? And what would be the transition

[2] Because relatively little federal support is provided to ILECs in California, carriers have little incentive to apply for ETC status. Western Wireless is the only competitive eligible telecommunication carrier (CETC) in California receiving FCC interstate access support, and there are no CETCs in California receiving FCC high cost loop or interstate common line support.

for an ILEC that loses the auction? The Commission should carefully consider these questions as it develops its auction framework.

Third, the Commission should address the need for coordination with federal policy. While the Commission is not bound to the current federal framework, whatever it adopts in this proceeding should be designed to perform well, regardless of whether the FCC adopts its own long-term reform. The Commission may wish to discuss with the FCC possible areas for cooperation, and possible ways to work together to address any areas where state and federal policies affect one another.

From a procedural standpoint, Verizon recommends the Commission solicit additional comments on these considerations before making decisions concerning using auctions in California.

2.1.1. Are there any statutory limitations to designating COLRs through an auction process?

No. As stated in Section 739.3(c) of the code, "[t]he commission shall develop, implement, and maintain a suitable, competitively neutral, and broad based program to establish a fair and equitable local rate support structure aided by universal service rate support to telephone corporations serving areas where the cost of providing services exceeds rates charged by providers, as determined by the commission." The subsection further states, "[e]xcept as otherwise explicitly provided, this subdivision does not limit the manner in which the commission collects and disburses funds, and does not limit the manner in which it may include or exclude the revenue of contributing entities in structuring the program."

2.1.2. What processes and protocols should be established to implement a reverse auction for purposes of assigning COLR obligations and setting the level of subsidy support in high-cost areas served by the existing incumbents? Is a descending bid, simultaneous-close auction the best type of auction to determine support?

a. Geographic Areas Subject To Auction

In order to target universal service support, auctions for universal service should be held using relatively small geographic areas. At the same time, these areas should not be so small as to create undue complexity, either for the auction administrator or for the participants. In its universal service auction proposal at the FCC, Verizon has proposed using wire centers, or zones within wire centers, as the geographic units to be auctioned. While Verizon continues to believe that this is a valid approach, the California B-Fund is already based on Census Block Groups (CBGs), and Verizon suggests that these units also strike a reasonable balance between targeting and administrative convenience. CBGs, or in some cases, the part of a CBG that is in the ILEC's serving territory,[3] could therefore serve as the geographic building blocks for the auction. The following discussion assumes that CBGs are the relevant geographic building blocks for the auction.

Verizon proposes that bidders be allowed to place bids in "packages." A bidder could submit a bid for a single area, or a package bid for a group of areas. For example, a bidder may submit a package bid if the bidder believes that it could serve a group of areas within the package more efficiently than the individual areas separately. This type of bidding process is called a "combinatorial" auction. In an auction of this kind, bidders, based on their own business plan and market forecasts, determine whether to bid on individual areas separately or in a group. Rather than regulators deciding how geographic areas should be grouped together, the Commission would obtain this information from the market through the decisions of the bidders. This allows for more precise targeting of support, while at the same time giving bidders more flexibility to plan their market entry in ways that fit their technologies and business plans.

b. Request For Quote.

The reverse auction process starts with a standard request for quote ("RFQ"), a document that invites a qualified carrier to submit a bid. It identifies

[3] In cases where the ILEC's serving territory does not include the entire CBG, it would not be reasonable to include the entire CBG as the geographic area subject to auction since the ILEC is not the COLR everywhere in the CBG. In those cases, the CBG would be subdivided by ILEC serving territory.

the services to be supported and provides sufficient detail about other terms of the contract so that bidders can reasonably decide how much to bid to provide the supported service in that area. The Commission should develop a "model" RFQ though technical workshops, to identify the supported services (e.g., primary line residential service) the bidder would be required to provide, as well as any other terms that would have to be satisfied, to qualify for support. However, any new and onerous requirements should be carefully considered, as they will either deter prospective bidders or cause them to raise their bids. Indeed, by allowing the market to place a value on any requirement in an RFQ, the auction process would give the Commission the incentive to accept only those requirements whose benefits outweighed their costs, since ultimately any increase in bids attributable to the requirements in the RFQ would be paid for by the B-Fund.

Moreover, while the Commission should not, and in many instances could not, directly regulate the rates or other terms of service of winning bidders, it should specify in the RFQ that the winning bidder is eligible to receive support only to the extent it offers basic service priced below the benchmark. As discussed further in response to question 3.3 below, D.07-09-020 requires COLRs to certify that basic service is offered at or below the benchmark to receive support.

Because the RFQ would set forth the terms of the contract between the winner of the auction and the Commission, the terms of which would not apply to any other provider in the area, the RFQ and the resulting contract should be entirely consistent. In order to avoid any possible inconsistencies, the RFQ should include the proposed contract.

c. Nomination of Areas for Bidding

The Commission should consider the process through which it selects areas to be auctioned. The first step is to identify those areas that are truly high cost and where a subsidy is needed for any entity to economically provide service at affordable levels. Then, in order to hold an auction in a given high cost

area, the Commission should have some assurance that there are at least two qualified bidders. Verizon suggests that qualified bidders themselves nominate areas for bidding, which would allow an area to come to auction as bidders are qualified and ready to participate in an auction for that area, given their own business plans.

Alternatively, the Commission may also wish to nominate areas on its own motion, or limit the areas available for nomination by qualified bidders. For example, the Commission may wish to begin with a pilot program in certain areas in order to gain experience before opening larger areas of the state to nomination. The steps in which auctions could be implemented would also depend in part on the Commission's conclusions regarding the issues raised by general auctions, as mentioned above.

In administering the bidding process, the Commission should establish a regular schedule of events that would include nomination of areas for bidding, registration of bidders, posting of deposits, and the bidding process itself – all which would make up the bidding cycle. Firm deadlines also will be necessary for the events in each bidding cycle.

d. The Bidding Process.

The form of the bid would be a flat amount of high cost support, which would represent the total annual support payment the carrier would accept in order to take on the universal service obligation in a given high cost area and enter into a contract. Having each bidder bid a flat dollar amount would simplify the bidding process. Each bidder would bid based on its own business plan and cost structure and its assessment of the market, including estimated revenues, costs, and total demand likely to be involved if the bidder were to win the bid. This approach puts the responsibility for determining all of these factors where it belongs – with the bidders themselves, which are much better suited than the Commission to make such determinations.

Basing bids on a flat amount rather than per-line support would avoid many contentious issues, such as whether to support primary lines, additional

lines, and multiple handsets. It would also avoid the potential issue of determining which carrier serves the primary line to a household with both a landline and a wireless handset. For instance, if a wireless carrier wins the auction but the ILEC still provides a landline, it is unclear whether the wireless carrier would qualify for any support based on primary lines. These kind of administrative complications would be avoided by basing bids on a flat amount.

More importantly, this approach would avoid distorting the incentives for the winning bidder in any given area to gain or lose a customer. The benefit to any winning bidder of gaining a customer would be the additional revenue it would obtain from that customer – not additional subsidies from the Commission, as is the case today. A flat amount of support would promote efficient competition among carriers and would allow competition to develop in areas that would economically support it.

e. The Auction Design.

As discussed above, there are numerous practical issues that need to be resolved before the specifics of auction design is addressed. Generally, however, Verizon recommends a "clock-proxy" model based on recent developments in auction theory to perform efficiently in the environment of a universal service auction. More detail on Verizon's recommended auction design is contain in Verizon's May 31, 2007 comments in response to a notice issued by the Federal-State Joint Board.[4]

f. The Auction Reserves.

The auction reserve, or maximum bid, is an important consideration in order to ensure that the auction process does not inflate, rather than act as a market-based mechanism to reduce, the amount of subsidies over time. In this context, the auction reserve ensures that the support awarded in any given area

[4] Comments of Verizon and Verizon Wireless, *In Matter of Federal-State Joint Board on Universal Service and High-Cost Universal Service Support,* WC Docket No. 05-337, CC Docket No. 96-45, May 31, 2007. These comments are available at: http://gullfoss2.fcc.gov/prod/ecfs/retrieve.cgi?native_or_pdf=pdf&id_document=6519508078.

in the auction is no greater than the amount of support provided in that area prior to the auction. If the reserve is not met, then the auction will fail, and support would continue to be provided under the existing rules.

The reserve for each CBG should be amount of support distributed to that CBG prior to the auction. The amount of support in each CBG prior to the auction will be determined by the update to the HM 5.3 model, or the amount of current support, depending on the timing of the auction. The software used to administer the auction would ensure that no bid exceeding the reserve would be accepted.

g. The Contract.

If the reserves have been met, the auction will select a provider of universal service in the area, and determine the flat annual amount of support that provider will receive. The rights and obligations of the winner will be memorialized in a contract. The Commission would execute the contract with the winning bidder and that contract will spell out the obligations of the winning bidder, consistent with the RFQ. As with the RFQ, the Commission should develop a "model" contract through the workshop process, which would detail the supported services and other requirements to which the winning bidder would be subject.

The winning bidder would be required to honor all provisions of the contract and, as in any other government procurement, the consequences of any breach would be spelled out in the contract. Depending on the severity of the breach, such terms could include penalties for non-performance, forfeiture of support received or any bonds posted, termination of the contract and, ultimately, debarment from participation in future auctions. The support amounts would be paid out over time, perhaps quarterly, rather than in a lump sum, to provide another ongoing incentive for the winner to maintain its performance. Similarly, the Commission would retain its authority to audit, investigate, and remedy fraud and abuse.

In the initial rounds, the contract should be for a term long enough to make the auction attractive to bidders and to give the winning bidder adequate opportunity to earn a reasonable return on its investment. On the other hand, the process should not create a "universal service incumbent" which excludes carriers that do not win the bid from a meaningful opportunity to bid again, particularly when technologies continue to develop and the efficiencies of providers continue to evolve. Under the circumstances, a five-year term appropriately balances these two considerations.

Once the auctions have been completed and the contracts executed, the Commission should publish the auction results on a website, including the identity of the winning bidders and the amount of the winning bids. This information would be available for use by any bidder in formulating bids in future auctions.

h. Post-Auction Process.

Auctions by definition produce winners and losers and, under Verizon's proposal, a carrier receiving support may no longer continue to do so if it loses the auction. A carrier that does not win the bid, of course, will have the opportunity to bid again when the contract with the winning bidder expires or, in the meantime, could submit bids in auctions for other areas. Nevertheless, the Commission should consider a number of issues when a carrier loses support, including a transition period, the transfer of COLR requirements, and other regulatory obligations. Each of these is discussed below.

(1) Transition Periods.

If the result of an auction changes the identity of the COLR in a particular area, then a transition will be necessary, both for the new COLR to take up its responsibility and for the existing COLR to relinquish it in that area. As a practical matter, since almost all of the COLRs in California today are ILECs, such a transition will involve an ILEC losing its support, and a new COLR taking on a new responsibility.

This transition period – perhaps one year – will ensure that no service gaps occur before the new universal service provider assumes the obligation to provide supported services throughout the auction area consistent with its contract. Such transition issues are similar to the process currently in place to allow ETCs to relinquish their ETC status as required by 47 C.F.R. § 54.205. The Commission should require the winning carrier to propose an implementation plan.

(2) Regulatory Obligations.

It is appropriate to relieve the carrier, including the incumbent LEC, of its COLR obligations in the event it loses high cost support. The purpose of holding the auction is to select a COLR who is willing to serve an area at the lowest cost to the B-Fund. Therefore, losing carriers should be relieved of that obligation. Also, there should be no need to regulate the retail prices of an incumbent LEC that has lost an auction. The incumbent LEC will have to compete for customers that the winning bidder has won the right to serve, and the incumbent LEC will be unable to do so successfully by raising prices.

Findings regarding such issues should be made clear prior to the auction so that qualified bidders can plan accordingly in submitting their bids.

2.1.3. The auction mechanism will require a bidding process predicated upon appropriate parameters of acceptable COLR service. What eligibility criteria for carriers and service quality standards should be established as a basis for reverse auction bidding? For example, what minimum standard of reliable 911 service would be necessary to qualify as a COLR as a result of a reverse auction bid? Should COLR status be granted for only a limited time subject to periodic renewal? If so, what should be the duration of COLR status?

To the extent the Commission requires a winning bidder to accept COLR obligations in a given area in order to qualify for support in that area, the obligation should be to provide service throughout the geographic area in which it will receive support as specified in its contract. As discussed above, all service requirements should be specified upfront in the RFQ so carriers can work these

requirements into their cost estimates. New or onerous requirements should be avoided because they would deter prospective bidders from participating, or increase the cost of providing service, which would be reflected in higher bids. Also as discussed above, Verizon proposes a contract term of five years from the date the winning bidder assumes its responsibility.

2.1.4. Should threshold standards, such as financial fitness, be adopted to qualify to bid in the auction? Should there be a bond required?

When qualifying bidders to the auction, the Commission should focus on the applicant's resources and capabilities. The threshold standards of financial fitness to qualify should be done on a case by case basis. A qualified bidder should be able to demonstrate that it has the resources and capabilities to provide ubiquitous service to the geographic area it will serve. In this regard, the RFQ/contract should require a bond. In the event the carrier fails to meet the terms of the contract, penalties could include fines or forfeiture of bond amounts, or the carrier could be barred from participation in any subsequent auctions. Thus, a bond requirement is part of the incentive structure for good performance.

2.1.5. What sorts of regulatory compliance requirements should apply to a selected bidder? Should reliability standards be placed on COLRs? What Commission audit requirements may be warranted to verify and confirm that a winning bidder follows through with commitments to meet such specified minimum basic service quality standards? Should any penalties for withdrawal, such as the difference between the winning bid amount and the next carrier or reauction bid amount, be imposed?

The winning bidder must be willing to comply with the terms of the contract in order to receive support. All standards and requirements should be detailed in the contract so there is no ambiguity as to what is being agreed to, and should not be any higher than for other carriers. As discussed elsewhere, the winning bidder must provide service ubiquitously in the geographic area for which it will receive support. The Commission should monitor the winning bidder to ensure that it is providing service throughout its COLR area. This could be as simple as calling the carrier and requesting service to various addresses within the area.

The winning bidder has a contractual obligation to provide universal service. If it withdraws from the contract, there should be consequences such as penalties for non-performance, forfeiture of support received or any bonds posted, and exclusion from participation in future auctions. Penalizing the carrier the difference between the winning bid amount and the next carrier or reauction bid amount would be reasonable. Specific penalties that would be appropriate to include as part of the contract can be the addressed in workshops.

2.1.6. What service(s) should be included within the bid covered by the reverse auction? (Parties may incorporate, by reference, comments on CASF issues, to the extent deemed relevant.) What limitations or conditions should be placed on service(s) that may be included within (or excluded from) the bidding? Are there other elements that should be part of bid than the amount of universal service support for the specific area? Should bids to be placed on total support, support per subscriber, support per household, or some other basis?

The carrier is bidding for support for the provisioning of basic service in the area. However, no limitations should be placed on other services that can be provided.

As discussed above, an auction for universal service support is analogous to a procurement contract. In some procurement processes, all aspects of the requirements of the purchaser are specified in the RFQ. This approach allows the bidding process to be relatively simple, since the only element of the bid is the price (in this case, the flat amount of support per year). Further, an auction structured in this way is transparent. Clear rules, established before the auction begins, determine how the winning bid is chosen. Subjective policy judgments may be involved in structuring the auction and choosing the requirements to be included in the RFQ. However, once the auction begins, the auction administrator simply follows the rules, and need make no subjective judgments.

In other procurement processes, bidders make proposals that may differ in certain respects, such as quality. In order to compare such differing bids, the auction administrator must somehow assign a value to the elements where the bids differ. This requires the administrator to make subjective judgments in order

to select the winner, and the result of the auction is no longer transparent or replicable. Alternatively, the Commission would have to supply the auction administrator in advance with some sort of weighting scheme that would allow the administrator to assign a value to all aspects of any possible proposal. This would be extremely complex.

Verizon urges the Commission to adopt a simple, transparent framework in which the auction depends only on the support amount bid. If the RFQ is carefully crafted, it can ensure that the result of the auction meets the Commission's goals for universal service, but does not restrict winning bidders from offering new and innovative services, many of which might go beyond the minimum requirements of the contract.

As discussed above, the bid should be a flat amount for total support, not per subscriber or per line.

2.1.7. In what geographic area(s) should the initial auctions be held? How many separate auctions will be required? What is the appropriate transition time to phase-out existing COLR support and phase-in new COLR support? Should the same timeframe be used to phase-in coverage and other COLR obligations? Should build-out benchmarks be established?

As discussed above, a nomination process would ensure that areas are auctioned only as qualified bidders are available and willing to bid in those areas. Also, as discussed above, a transition period – perhaps one year – will be necessary when a party other than the existing provider wins an auction.

2.1.8. Should one particular area be selected for a pilot project to test the operation of a reverse auction? If so, based upon what considerations?

A pilot project to test the operation of a reverse auction is reasonable. However, it need not be confined to a single area since carriers may derive synergies from operating in multiple areas. As the process of qualifying bidders proceeds, the Commission may wish to select a limited set of CBGs where qualified bidders are available, and begin by opening that set to nomination.

2.1.9. Should only one COLR be selected for each area, or should reduced subsidies be available to qualifying competitive carriers?

Consistent with targeted support and economic principles, only one entity should have a COLR obligation in each supported area, and accepting that obligation should be a condition to receive support in that area. Having a single COLR will simplify the auction process and will encourage carriers to bide as aggressively as possible. It also obviates the need to divide the support among multiple winners, with the attendant problems of determining a basis for this division, such as lines or handsets.

2.1.10. Should the size of the service area subject to reverse auction bidding be set by the Commission or determined by the bidding process?

As discussed above, Verizon proposes that the Commission should establish the basic geographic "building blocks" for the auction. Establishing an existing, standard area eliminates the ability of any participant to gerrymander the process. The Commission has already chosen the CBG as the geographic unit for the B-fund for exactly this reason. The CBG would also be suitable as the basic building block for the auction framework.

However, once this framework has been set, each participant can determine the combination of these building blocks that best corresponds to its own business plan. The nomination process is designed to ensure this by allowing all registered bidders to nominate areas. And the combinatorial auction design allows each bidder to bid on any "package" of CBGs it chooses (and for which it is qualified) in any given round of the auction.

2.1.11. What is a reasonable cost proxy to serve as an initial auction "reserve" or upper bound on bids that would be acceptable as the basis for payment of support levels? What is the most expeditious manner to derive an appropriate benchmark for setting such upper bounds? As a default, should any qualifying upper bid be at or below the existing B-Fund support level for designated areas subject to the auction? If the HM 5.3 Model is used to designate areas subject to the auction, should a cap be placed on the results? What is a reasonable cap?

As discussed above, the reserve should be the amount of support distributed to an area before the auction. This would ensure that the amount of support cannot increase as a result of the auction.

2.1.12. What sorts of cost proxy determinations or updates may be necessary or desirable as a basis to identify areas subject to bidding under the reverse auction? Is there a better approach to forecast service needs of the area for the duration of the COLR designation?

Cost proxy models are inherently unreliable and inaccurate as a mechanism to determine *absolute* cost levels. They are somewhat more useful for purposes of determining *relative* cost levels between various geographic areas, as is the case in determining areas eligible for high cost subsidies. Here, the commission has already determined in Phase I that it will use an updated cost model to determine the relative cost levels throughout the state, and therefore, the updates to the HM 5.3 model would determine the amount of support distributed to each area which will determine the areas subject to bidding under the reverse auction. If there is a high risk that the HM 5.3 model will not identify all high cost areas, the Commission could consider allocating a percentage of the amount of B-Fund support reduction from the auction process for purposes of funding additional areas. The burden of proof that any new or additional area is high cost would be with the carrier or community involved. Once the Commission has agreed to include a new area as eligible for B-Fund support, competitive bidding could be used to select a COLR for that area and determine the compensation that the winning bidder would receive. The reserves for these new auctions could be set to ensure that the amount of any new B-Fund support awarded could not exceed the amount allocated by the Commission for that purpose.

Once the auction process is well established, and auctions have been held in a number of areas, it should be possible to develop a statistical model, based on the results of those auctions, that relates the amount of the bid necessary to win an auction to the characteristics of the area, such as density. At that point, the Commission may consider using estimates from this statistical

model, rather than cost estimates, to set reserves for subsequent auctions. This approach has been used successfully in other applications, and is called "representative bidding."

2.1.13. If an existing ILEC COLR does not submit a selected bid during the auction, should there be any additional requirements that the ILEC make its existing facilities in the designated area available to a new COLR?

No. This is not to suggest that the winner of the auction and the loser might not arrive at some voluntary commercial agreement under which some network services are provided to the winner. But that is a make-or-buy decision that should be separate from the auction itself. As a practical matter, in California most of the qualified bidders other than ILECs are likely to be wireless carriers who in most cases already have their own separate infrastructure.

B. COST PROXY MODEL UPDATE IMPLEMENTATION

2.2.1. In order to mitigate the risks that the HM 5.3 Model may produce anomalous results, how, or in what manner, should the total investment calculation produced by the HM 5.3 Model be capped to avoid excessive subsidies?

As noted above, cost proxy models are inherently unreliable and inaccurate as a mechanism to determine absolute cost levels, although somewhat more useful for purposes of determining relative cost levels between various geographic areas. Thus, recognizing this distinction, the PUC should not strive for perfection but only for the most reasonable relative cost estimates possible, given the complexity of the task before it, and not attempt to arbitrarily adjust the model at the outset to "fit" a desired policy result. Although acknowledging flaws in HM 5.3,[5] the PUC nonetheless found HM 5.3 to be TELRIC compliant and approved its use for setting permanent deaveraged UNE rates for both then-SBC and Verizon. Verizon criticized HM 5.3 extensively in Verizon's UNE proceeding for producing cost results that were erroneously low. Capping investment would further compound these problems with HM 5.3. In

[5] Verizon UNE Phase, D.06-03-025, at 56.

addition, capping the total investment for USF purposes to avoid "excessive subsidies" inappropriately violates the consensus costing principles, as the capped investment would no longer model "total demand" for network elements.

Very high cost results in certain areas are not necessarily "anomalous" simply because they are high, particularly when there are admittedly very low density, rural areas in CA and such models are somewhat better at producing relative cost levels. Such disparate costs should not therefore be automatically discarded without further examination. Any effort to cap results based on the view that they will be anomalous could itself skew auction results, as they will be used to establish reserve levels for use in the auction, and artificial results may impact the success of the auction. If HM 5.3 produces very high costs in a particular area and alternative technologies may be more cost effective than wireline, the auction process will reduce support through market considerations. However, arbitrarily reducing any cost result above a certain level may eliminate the potential of an auction because the starting point (reserve level) is too low.

In short, the Commission should strive for a reasonable level of relative accuracy and avoid an arbitrary cap on total investment.

2.2.2. Why should any other adjustments be considered?

Some adjustments will be required to update the model or to make the model usable for all areas in California. In addition, some will be required because of the determinations made by the Commission in D.07-09-020. For example, the current model only estimates cost at the wire-center level, so census-block group deaveraging calculations have to be developed and incorporated.

The HM 5.3 model used to calculate B-fund costs should use a common set of inputs for all areas in California. Therefore, any carrier specific inputs in the base model will need to be analyzed and potentially updated and/or modified. Parties should be permitted to analyze the HM 5.3 model to be used in calculating B-fund support so that a complete list of adjustments can be recommended. If, for example, the HM 5.3 model run used in the Verizon UNE

proceeding is the base run, then changes to update the inputs, and more importantly, modify carrier specific results, would be necessary.

Verizon recommends a limited number of platform changes be incorporated in order to improve relative accuracy. *First*, the model should be revised so that geocoding customers and assigning cable routes along existing roads to be more realistic. Verizon has found that when populated with appropriate inputs along with its road-based, minimum-span routing, the model appears to yield more realistic network clusters or distribution areas. *Second*, the model should be revised to recognize the costs associated with the COLR obligation imposed upon ILECs. Specifically, as a COLR is obligated to serve all customers in the designated area, facilities must be constructed to serve all housing units, even if some are served by competitors. Therefore, the costs to build to the entire area should be assigned or recovered over working lines. These changes would improve the accuracy of the cost proxy results.

Verizon also recommends a number of model input adjustments to improve the accuracy of USF cost estimates, including:

a) If the Commission decides not to make the suggested changes to the model platform, input changes should be allowed to capture their impacts to the extent possible.

b) Significant network component prices, e.g. cables, structures and electronics, should be updated to reflect material changes in the time since the inputs were developed for the UNE proceeding.

c) Costs of labor should be updated.

d) Expense inputs should be updated.

e) Sharing assumptions should be revisited to assess their continued reasonableness.

2.2.3. What other possible adjustments to the cost proxy should be considered in order to avoid excessive subsidies, (e.g., limiting support only to the operations and maintenance costs for existing lines as derived from the model)?

As noted above, improved relative accuracy should guide any cost model adjustments. Excessive subsidies should be capped by not allowing the overall level of funding to increase.

2.2.4. What other adjustments to the HM 5.3 model may be appropriate to streamline the updating process while ensuring that the resulting cost proxies are reasonable for deriving B-Fund support levels as an interim transition to the reverse auction?

Parties may identify the need for other adjustments after the HM 5.3 model is reviewed and analyzed. The Commission should not limit model adjustments to particular inputs, for example, until parties have had the opportunity to analyze the model.

2.2.5. What procedural measures may be necessary in order to facilitate the timely production of cost model runs, provision for discovery, protection of proprietary data, and other measures to develop an adequate record on cost model updates?

The Commission should first distribute the HM 5.3 model that will be used as a basis for comment and adjustment. To the extent certain input values are proprietary, parties can use standard non-disclosure agreements. The HM 5.3 model run should allow parties to reasonably understand how costs are derived by:

a. Providing access to all interested parties to the model and all underlying data, formulae, computations, software, engineering assumptions, and outputs;

b. Allowing interested parties to examine and modify the critical assumptions and engineering principles; and

c. Generally replicate the cost model or cost study calculations.

Parties should then have the opportunity to modify the platform, update input values, and file their model with proposed modifications, along with comments describing the changes. Parties should be given eight weeks to complete the model analysis, make changes, and complete a filing. Documentation supporting the filing should be distributed to parties that have

executed non-disclosure agreements simultaneous with the filing. An additional eight weeks should be allowed for parties to analyze filed model runs, issue discovery, and file reply comments. The cut-off for issuing discovery should four weeks after receiving the documentation.

Based on the filed model runs and comments, the commission staff should determine the model modifications and input values to change, produce an interim model run, and describe the preliminary changes to the model in a staff report. If necessary, staff could lead a workshop to describe the changes made to the model. Following comment on the staff report and interim model run, the staff would incorporate suggested changes into a final cost study run.

C. OTHER PHASE II ISSUES

3.1. Transitional Basic Rate Caps

(a) To promote an orderly transition and prevent sudden large rate increases, what maximum level above the currently authorized caps should be set as the revised cap on basic rates for each respective ILEC before full pricing flexibility is to take effect?

(b) What period of time is appropriate for the phase-in of increases in the caps on ILEC basic rates to transition from current levels to a level at which further cap restrictions can be eliminated and full pricing flexibility implemented?

As Verizon has stated in previous comments, the concept of a rate cap is fundamentally inconsistent with the Commission's determination in the URF Decision to allow competition to set just and reasonable rates for all services. The Commission's Phase 1 decision in this proceeding, D.07-09-020, determined that a limited transition period was appropriate to phase into full pricing flexibility so as to mitigate any rate shock that might occur as rates increase.[6] Nonetheless, D.07-09-020 recognizes the ultimate goal of full pricing flexibility and provides that, after the transition period, basic rates will no longer be capped

[6] Verizon maintains its position that rate shock need not be a major concern, but presents these comments in response to the Commission's decision to implement a transition period so as to mitigate rate shock.

and will instead be subject to the pricing flexibility adopted for all other services in URF.

The Commission must be mindful of the fact that setting rate caps in a competitive environment is not a benign action. Price caps cause market distortions, such as slowing market entry by intermodal carriers. Accordingly, the transition period must be kept as short as possible consistent with the Commission's goal of avoiding rate shock, but not so long as to stifle innovation and development in this fast-changing market. Verizon proposes a maximum three-year transition period as reasonable and consistent with the Commission's historical policies regarding rates.

Recognizing the current rate disparity between Verizon and AT&T, Verizon proposes that the transitional benchmarks, as well as the target cap at the close of the transition period, need not and should not be the same for each carrier. In addition, the target cap at the end of the transition need not be $36, but neither should it be so much less than that amount as to run the risk (in the Commission's view) of further rate shock once full pricing flexibility begins. Verizon proposes an illustrative example of how the rates for these two carriers could be increased in a consistent way over a three year period; rates for other affected carriers are not included but could be handled in a like manner. This transitional rate proposal is set forth in Attachment A.

Under Verizon's proposal, fifty percent of the difference between the $36 benchmark and the sum of the carrier's basic service price plus SLC would form the basis for a transition cap. For Verizon, $36 (benchmark) - $17.66 (rate)[7] + $6.50 (SLC) = $11.84. Half of that amount, $5.92, would be the amount by which Verizon's basic rate cap would increase over the three-year transition, to a final rate cap (including SLC) of $30.08. Verizon proposes to implement the increase using 7.6% annual increases each year to the basic service price. For AT&T, the target increase amount ($10.34) is higher in recognition of the lower starting rates, and would be implemented by annual increases to the cap of 18.80% over

[7] This will be Verizon's rate as of January 1, 2008, taking into account the Consumer Price Index based increase authorized by D.07-09-020.

a three-year period to a final rate cap (including SLC) of $25.66. This latter increase is consistent with the $6.05 effective rate increases implemented for Verizon and the $2.90 increase for AT&T at the outset of the Commission's Implementation Rate Design proceeding in 1995,[8] and therefore should not present an issue of rate shock.

Verizon believes that its proposal appropriately balances the amount of permissible increases over a reasonable period of time, and does so in a manner that can be tailored to individual carrier's different rates. This will provide a reasonable transition to the Commission's ultimate goal of full pricing flexibility where prices are set by the market.

3.2. Certification Process to Qualify for B-Fund Support

What process should be implemented whereby the COLR shall certify that its services and rates in high cost areas are reasonably comparable to services offered in urban areas once full pricing flexibility takes effect?

The Phase I Decision indicated that COLRs would be required to certify annually that it is not charging rates for basic service in excess of the benchmark levels.[9] A simple certification process is appropriate for a number of reasons. COLR price increases above the benchmark rate in high cost areas will reduce the COLR's CHCF-B funding on a dollar for dollar basis. This reduced funding will create an automatic disincentive to price above the benchmark in high cost areas. Therefore, the reasonably comparable certification process should be coordinated with the timing of federal high-cost support certification that is due each year by October 1st. The certification should consist of a simple attestation by an officer of the COLR that in high-cost areas, it offers a service that meets the revised basic service elements (discussed below in 3.3), at a price that is no higher than the current benchmark.

3.3. Broadening the Base for Eligibility to Receive B-Fund support

[8] See D.94-09-065 at 41-46.
[9] See D.07-09-020, Ord. Para. 9

Should existing rules for eligibility to receive B-Fund support be modified to accommodate a broader based of eligibility for B-Fund support to include wireless and other intermodal carriers? Comments are solicited as to the merits of such a modification as a way to promote competitive neutrality in the allocation of B-Fund support, consistent with public policy goals.

Broadening the base of eligible carriers must be considered both for areas that are auctioned and for those that are not. Expanding eligibility using an auction process was discussed above. If the commission also expands eligibility in high cost areas that are not subject to an auction, several considerations must addressed.

First, carriers should receive support only if they choose to accept COLR obligations in that area, and this should be true for intermodal providers as well. To the extent possible, COLR obligations should be competitively neutral so that one type of carrier is not unfairly burdened, and the B-fund rules do not distort the competitive market. To accomplish these goals, the existing COLR designation process[10] should apply to all intermodal carriers that choose to seek B-Fund support.

Second, areas eligible for support should be determined for all carriers by the results of the statewide cost model, i.e., on a CBG basis using the $36 benchmark. Although the cost structure of intermodal providers may be different than the wireline results produced by HM 5.3, high cost areas, and the amount of support in those areas, should not be modified for intermodal networks. In areas that are not auctioned, the ILEC will remain a COLR, and support should compensate for that obligation.

Third, to avoid expanding the size of the fund, funding must continue to be limited to one connection per household.[11] In areas that are auctioned, only one carrier will be the COLR. In other areas, however, two or more carriers may be certified COLRs, although the overall level of support should not increase as a result. In these areas, the commission must take steps to avoid multiple

[10] D.96-10-066, Appendix B, Rule 6.D.4.
[11] D.96-10-066, Appendix B, Rule 6.C.1 "The CHCF-B will apply only to residential basic service, priced at the tariffed rate, in high cost GSAs. Only one residential line per household shall be subsidized."

connections receiving support. One option is to limit support to one primary connection per address, and require carriers to report customer addresses with claims. Duplicative payments can then be identified and resolved through customer certification of the primary line.

Fourth, because the COLR designation requires the carrier to provide basic service throughout an area, the Commission should review the basic service definition in D.96-10-066[12] to determine if changes are necessary in a context where intermodal providers could qualify for support. Parties should have the opportunity to submit comments on the definition of basic service so that eligibility can be extended to intermodal providers.

In addition to offering basic service throughout the high cost area, D.07-09-020 requires the COLR to certify annually that it is not charging rates for basic service in excess of the benchmark.[13] Therefore, an intermodal provider should provide its customers a service option in the area where it is receiving support that is consistent with the basic local service definition that is priced below the benchmark as a condition to receive support.

b) What other considerations or revisions in existing rules may be appropriate or necessary to accommodate such a change?

Lifeline requirements need to be addressed, but they are the subject of another proceeding.

3.4. Standards/Procedures for Future Period Review of the B-Fund Program

What standards and procedures should be applied for future periodic review of the B-Fund program in order to ensure that the program continues to be effective in meeting the Commission's universal service goals?

Verizon believes that responding to this issue when so many of the phase II issues are undecided is premature. Once the Commission has determined

[12] D.96-10-066, Appendix B, Rule 4.B.
[13] D.07-09-020, OP 9.

what additional modifications to the B-Fund are appropriate, Verizon will be in a better position to recommend criterion for future periodic reviews.

3.5. Streamlined Administration of B-Fund Receipts and Disbursements

Through what standards and procedures can the administration of the B-Fund program be made more streamlined and efficient?

The Phase I changes to the B-Fund mechanism will greatly reduce the volume of activity associated with administration as the reforms are implemented and the number of CBGs eligible for support are reduced. Once the benchmark transitions to $36, reporting of rates charged for basic service below the benchmark can be eliminated, as support will be calculated as the difference between the benchmark and CBG cost.

CONCLUSION

The foregoing preliminary comments respond to the issues set forth in the ruling. Verizon looks forward to providing additional detail in reply comments as well as subsequent workshops or other proceedings following this round of comments, as contemplated in the Ruling.

DATED: November 9, 2007

Respectfully submitted,

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Attachment A

Analysis of Transition Proposal Over Three Years

Row #		Verizon CA	AT&T
1	Basic Flat-Rated Residential (1/1/08)	$ 17.66	$ 10.94
2	Subscriber Line Charge	$ 6.50	$ 4.38
3	Total	$ 24.16	$ 15.32
4	Benchmark	$ 36.00	$ 36.00
5	Difference (Row 4 - 3)	$ 11.84	$ 20.68
6	50% of Difference	$ 5.92	$ 10.34
7	Transition Cap Target (Row 3 + 6)	$ 30.08	$ 25.66
	Annual Increase Percentage	7.6%	18.8%
	Basic Service Cap Increase		
	Year 1	$ 1.83	$ 2.87
	Year 2	$ 1.97	$ 3.41
	Year 3	$ 2.12	$ 4.05
	Total	$ 5.92	$ 10.34

CERTIFICATE OF SERVICE

I hereby certify that: I am over the age of eighteen years and not a party to the within entitled action; my business address is 711 Van Ness, Suite 300, San Francisco, CA 94102; I have this day served a copy of the foregoing, **COMMENTS OF VERIZON REGARDING THE OCTOBER 5, 2007 ASSIGNED COMMISSIONER'S RULING ON ISSUES RELATING TO THE SCOPING AND SCHEDULING OF PHASE II ISSUES** by electronic mail to those who have provided an e-mail address and by U.S. Mail to those who have not, on the service list.

I declare under penalty of perjury that the foregoing is true and correct. Executed this 9th day of November, 2007 at San Francisco, California.

/s/ Thomas Bird

Thomas Bird

CALIFORNIA PUBLIC UTILITIES COMMISSION
Service Lists

PROCEEDING: R0606028 - CPUC - OIR INTO THE
FILER: CPUC
LIST NAME: LIST
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